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Life Company Trends, as Seen Through the Eyes of the Chief/Corporate Actuary

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Moderator: PATRICIA L. GUINN

Panelists: HELEN GALT
DOUGLAS MENKES

Recorder: PATRICIA L. GUINN

Summary: Chief actuaries or corporate actuaries of life companies are well positioned to spot the trends and potential problems affecting their companies and actuarial positions within the companies. However, they don't always have the resources to cope with them. In this session, the panel spotlights the trends and problems, using the results of an intercompany survey of chief actuaries. Then, the chief/corporate actuaries from a stock and a mutual life company describe how their companies are affected by these trends, how they will cope with them, and possible implications for other actuaries in the company.

Ms. Patricia L. Guinn: I'm managing principal for the Tillinghast Life Division. The panelists are Helen Galt who is company actuary for the Prudential. She is responsible for oversight of all of Prudential's actuarial operations on both the life and property/casualty side. She's also ahead of corporate risk management for the Pru. Doug Menkes recently changed career paths from consulting to company. He joined the Equitable three months ago as the corporate actuary and is responsible for virtually all the actuarial work that goes on at the Equitable, including the pricing, valuation, and financial analysis areas.

We're going to start with going over the highlights of a survey that has just been completed. We've asked chief and corporate actuaries to identify the major issues they face and that their companies face. Then Helen and Doug are going to offer up their comments. They come from a mutual and stock environment.

This survey that we're going to be presenting the results of is an update of one Tillinghast did in 1994. It's a companion to our life CEO survey that we do every two years. The most recently completed one is the 1997 CEO survey report that was released at the end of September 1997.

We mailed these surveys to 250 actuaries in the middle of August. We're pleased that we got a 44% response rate. The focus of the survey and what we're going to be talking about is the retail life and annuity side.

In terms of respondents, about two-thirds were from stock companies, and one-third are from mutual companies. There was a good cross section of respondents by company size. About 15% were below \$500 million in assets and 15% were above \$20 million. In terms of scope of operations, a little over half of the companies indicated that the scope of their operations was U.S. or national. About 20% targeted themselves as either North American or international, and the balance were regional or niche players.

Let's start by highlighting some of the key findings. Many questions were asked on the survey and we obtained a lot of good information. It's good to know that actuaries are sort of on the same page with their CEOs. They're in broad agreement with their CEOs about the issues that are facing the industry and their company. It's also quite interesting to note that actuaries are much more critical about how prepared their companies are to respond to these issues.

Actuaries are optimistic that opportunities exist to improve how they do their job, or how the companies operate in terms of measuring performance and managing financial performance. I'll discuss how there is a substantial proportion of companies that are not tracking the value added by new business or performing sophisticated analysis of actual and expected results.

Measuring and managing risk remains an important job for actuaries. This is a role that's particularly valued by senior management. Actuaries are more concerned about sales practices and market conduct issues than their CEOs. The actuaries main challenge in dealing with senior management seems to be largely a communication issue—communicating the implications of the trade-offs of various decisions that they make to senior management. With respect to the profession, actuaries are fairly optimistic, particularly those at large companies. They're optimistic about the future potential in both traditional and nontraditional roles. Let's look at the strategic issues. The top two strategic issues facing the life industry are the same for both CEOs and actuaries, and those are distribution channel productivity and increased competition. The number three issue for actuaries is market conduct. It's almost tied with expense management. That was chosen as

one of the top three issues by more than 40% of the actuaries. Now these two issues were farther down the list for CEOs, who seemed to be more concerned about fundamental market changes such as changes in customer demands. They were also concerned about capital management issues.

With one exception, actuaries are much less optimistic than their CEOs about how prepared their companies are to deal with these issues. For example, take the first issue— distribution channel productivity. One-third of the CEOs thought their companies were well prepared to deal with these issues, and less than half that proportion of actuaries felt that competent. The exception is market conduct. The actuaries are nearly twice as confident that their companies are well prepared to deal with these issues. I've tried to think of a reason why that flip in those responses might have occurred. It might be due to the actuaries fundamental belief in the soundness of the products that they developed and how they're managed.

We asked a lot of questions about product pricing and performance measurement. I'll just go over some of the highlights. Most actuaries are satisfied that their pricing methods and their targets are done well. They think they do a good job of reflecting the risks inherent in the product, and that they do a good job of reflecting cost of capital. Only 15% are very satisfied with their companies' ability to get at the real economic contribution of their various product lines. Within that 15% of very satisfied respondents is a lot of diversity in the responses by size of company. Only 7% of small companies and one-third of large companies were very satisfied.

Many companies are not annually determining the value added by new business. The mutual companies were only half as likely to go through a formal exercise of looking at value of new business each year. These proportions are much less than half for stock companies and less than a quarter for mutual companies, but the proportion actually looks high in light of the pricing and performance management framework that most companies are using today.

Much of the pricing is being done using traditional statutory profit measures or looking at GAAP profits and GAAP ROE, and only 8% of the companies are using embedded value or some sort of economic value added (EVA) framework to link pricing, performance measurements, and performance management in the companies.

So this is similar to our observation in 1994. There's plenty of scope for improvement in this area of financial performance measurement. In a way, we continue to be surprised that this hasn't hit the priority list for reengineering or quality initiative.

The next topic seems to be one that is moving up the priority list and that's risk management. If you just look at the upcoming agenda for Society seminars, this topic is getting a lot more attention and a much broader definition than it has in the past.

When corporate actuaries look at their job and what they spend their time on, risk management is an important role and is considered to be one of their most critical functions. In terms of how this function is being performed, the bulk of companies are using traditional C-1, C-2, C-3, and C-4 types of risk classification schemes and traditional tools like cash-flow testing and duration convexity analysis for measuring and controlling risk. In terms of looking out, they expect to use much more sophisticated tools. For example, they are using dynamic financial analysis and borrowing some of the probability of ruin work that our casualty actuarial brethren use.

When we look at what risks actuaries consider most problematic for their companies, it's interesting to note that interest rates are not at the top of the list. There is really a much more fundamental risk that's of most concern. That's the industry continuing to be a viable provider of the retail financial services product. Increased competition, new regulations, and changes in tax laws all attack the fundamental ability to continue doing business. These are the big concerns.

While market conduct was the number three strategic issue for actuaries, it's interesting to note that less than 10% thought that the market conduct lawsuits, the illustration regulation, or even Insurance Marketplace Standards Association (IMSA) would be a significant benefit to future customers. I thought this was a very interesting observation. When you combine both the significant and moderate benefit categories, you get a rating of about one-third. Less than 10% thought that these things were going to do anything dramatic.

On the other hand, there is widespread agreement that market conduct issues are having a big impact on distribution. It seems to me that the observation here is that actuaries think that the impact is more in the field than in the home office. The perceived impact of the sales illustration regulation is pretty much a nonevent with about two-thirds thinking that it either had a slight or no impact. This might be because companies saw it coming and were geared up by the time it came into effect.

IMSA is important. Seventy-five percent of the companies indicated that they plan to join, but it's not an activity that is being driven by the actuarial area. Few actuaries have significant involvement with their company joining IMSA.

Actuaries are continuing to face some challenges in their dealings with senior management. The number one issue remains the same as it was in our original survey in 1994, and that is developing profitable products. I'd be interested in hearing from both of our speakers and from the audience as to what that really means. Does that mean sort of balancing the three legs of the stool—keeping customers satisfied, having adequate profitability for the owner, and keeping the agency force happy? Or is it something else that people were really trying to get to with that response?

I also thought an interesting observation is the movement from 1994 to 1997 in the issue of management's overall understanding of actuarial principles and what we do. I think that the respondents must feel that they've done a good job at educating senior management. Either that or actuaries have moved into senior management.

Senior actuaries do feel involved at the highest levels of their companies and they feel that they're influential. Almost half rate their influence as significant, and they feel they've been very proactive in communicating their viewpoints.

Let's discuss the future. We asked what sort of nontraditional role do the actuaries take on in your company? We received a variety of responses. The most often quoted areas where actuaries are getting involved are in the marketing and sales area and in the investment area as well as systems. But there are actuaries who are taking on positions of responsibility in mergers and acquisitions (M&A) compliance, and asset/liability modeling (ALM) and executive management.

In terms of outlook, there's a lot of optimism that the opportunities in the profession look good. It was interesting to note that actuaries from large companies were much more optimistic than those from smaller companies. For the time being, the opportunities are seen more in traditional areas than in nontraditional areas.

Those are some very brief highlights of the survey results. As I mentioned, a report will be forthcoming. It will be out before the end of 1997.

Ms. Helen Galt: I'm certainly happy to see that there's such a good alignment between the chief actuaries' and the CFOs' views of the strategic issues facing the industry. What I will do is comment on my perspective of those issues, and then I'll talk more generally about our role as actuaries.

My number one issue, which is not surprising because I am from Prudential, was sales practices. It would certainly be hard to be at Prudential over the last couple of years and not name this as a major concern. I think that Prudential and the rest of the insurance industry will deal with sales practices, in a way that's fairest for past,

present, and future customers by remediating any harm that was done in the past and by making sure, going forward, that our products are designed and presented in a way that current and future customers can understand.

I don't mean to downplay the importance of sales practices in any way because it is an extremely important short-term issue for Prudential and for many of the other companies that are represented here. I don't think it's the most important long-term strategic issue that we face. I think some of the other challenges may, in fact, be harder to deal with. The concern about the productivity of our distribution channels is very well founded. In particular, many large mutual companies like Prudential rely very heavily on a career agency system that's looking increasingly expensive in today's highly competitive environment.

Now that's not to say that there won't be a continuing need for face-to-face selling. Many of the products that we offer can be characterized as high anxiety sales. Those are situations where the customer is being forced to deal with things that he doesn't want to confront, like the prospect of his own mortality, or situations such as retirement planning where I think the range of future options and future outcomes can be so confusing. Even the most sophisticated and motivated client can use a lot of help in figuring out what to do. I think that the basic issue here is matching the economics of the distribution system to the customer's needs and willingness to pay for advice.

Now some people would argue that the economics of face-to-face selling will continue to make sense, but only at the very high end of the market. For more commodity-like demand products, such as auto and homeowner's insurance, and perhaps term insurance and annuities, alternate channels of distribution, such as the Internet, might make more sense. The real challenge will be how to reach the middle and lower end of the insurance market with products like permanent life insurance that must be actively sold. Perhaps more workplace marketing of individual products is one answer to this dilemma.

We all recognize, as the survey showed, the increased competition in the financial services industry. We're seeing more mergers, more growth by acquisition, and more incursions by banks and securities firms. Two of the companies that are at the top of my worry list are GE Capital, which is continuing to grow its insurance business aggressively and American International Group (AIG), which is one of the toughest and most profitable property and casualty (P&C) companies. It has been showing much more interest in life insurance recently.

Changing markets and consumer demands was the third major strategic issue identified by both CEOs and chief actuaries. I think that customers are becoming

more demanding along three dimensions: (1) what products they want to purchase, (2) how they want to purchase them and how to obtain ongoing service after the sale, and (3) when they want access to initial information and ongoing service. These changes are going to have enormous implications for the future of the financial services industry. I think the good news is that no one has figured out how to meet all of those new demands. The bad news is that we're not sure who's going to figure it out first.

What's the unique role of the actuary in helping your company meet these strategic challenges? With respect to sales practices, I think the most important thing is that we all need to recognize our role as actuaries in helping to prevent these problems from occurring again. Many of us learned some hard lessons about how the sensitivity of dividend scales and other nonguaranteed elements of that product result. As the engineers of today's and tomorrow's products, we probably understand better than anyone whether a product is either a potentially high performance but unstable racing machine or a less exciting but predictable family sedan. Our job is to make sure that everyone involved in marketing and selling the product understands what's coming off the test track. Now I think that the attention that the actuarial profession has been given to disclosure issues on equity-indexed annuities is a very good sign that we've recognized that responsibility.

What can we do about the issue of distribution channel productivity? Other than trying to deliver attractive products, I think actuaries can also add value by dissecting the total cost of our current distribution system and communicating the results of that analysis. We're in an excellent position to recognize the total complexity of this issue because we quantify not only the obvious direct cost of any method of distribution, but also the longer term indirect effects of sales marketing and field underwriting or mortality and morbidity and persistency.

We also have an interesting challenge as our companies migrate toward alternate distribution channels in terms of choosing appropriate pricing assumptions for the products that will be sold through these channels and/or communicating the potential uncertainty of results. What can we do about increased competition and changing customer demand? I think that those two issues are very highly related because no company can be successful in competition in the long run, unless it meets customer demands. I think the actuaries can do a lot of what we've always done—innovate or copy the best ideas that are out there or modify existing projects to meet the demands of the marketplace. What will be different in the future is making very sure that all of the risks are understood. The customer must understand whatever risks are embedded in the products that they are buying, and the company must understand the risk that it is taking.

Risk management is a subject that has been receiving an increasing amount of attention in the profession over the last year or so. With a senior management team at Prudential, that comes primarily from the banking industry, where risk management techniques are generally more advanced than in the insurance industry. We've been focusing a lot of energy on this subject.

Now some of you may have heard me talk about this before. I'm going to summarize very briefly what Prudential has been doing. We've been looking at all phases of risk management, starting with the very broad strategic decisions that affect the company's risk profile. The first thing to recognize is that fundamental choice is about what products and services the company offers, what markets it targets, and how those products are going to be distributed. This will obviously have a profound effect on the risk profile of the company.

At Prudential we also talk a lot about the concept of smart risk. Smart risk is a risk that aligns with your business strategy. It's one that you understand, hopefully one that you can manage, and ideally one where you think your company has the competitive advantage in either sourcing the risk to begin with, or managing the risk once it's on your books. Now if you want to start some interesting dialogue in your company, go back and ask other people that you work with whether they think your company has its competitive advantage in either sourcing or managing risk. We've had some fascinating discussions about that subject.

Once the basic strategic decisions are made, then each of the building blocks of the risk management framework, such as risk identification, risk measurement, and policies and procedures for controlling risks, need to be examined. There are limits on the amounts and types of risk that you take, the management reports that you will use to monitor risk or the systems that you need to collect data in a timely manner. Last but not least, you need to know what kind of organization structure the company needs to have in place to assign clear responsibility for managing risk. Prudential is one of the few companies in the insurance industry that has established a risk management unit to put all of those structures in place. We're not there yet, but at least we're working on it. The role of the corporate risk management unit, which I had, is first, to try to make sure that risk takers in the company know what they're doing by making sure that proper risk identification processes are in place. Second, we must make sure that risk is being measured and communicated effectively, which means setting standards for how risk will be measured and assuring that timely reports are available to monitor where we are. Third, we must make sure that the company's risk profile is what it should be by reviewing and approving the policies and procedures and limits that are in place in the operating units to control risk. We must also collect and analyze enterprise data to make sure that the aggregate affect of the risks that are being taken and the

operating units end up being in line with our risk tolerance in overall company strategy. So our role in standard setting is synthesis and oversight. It is not to be active risk management in a sense.

In terms of specific projects, we have developed value-at-risk measures for most of our insurance liabilities and virtually all of our asset categories. Earlier this year we worked with some outside consultants to compile a complete inventory of all of the market credit and insurance risks that are being taken in the company as well as all of the current policies and procedures and limits that are in place to control them. I suspect few companies have actually gone through this kind of documentation process of all their risks. It is quite expensive and time consuming to do it, but I think it gives you a much better idea of where you are.

I think that risk management is an excellent opportunity for actuaries because a lot of the skills that you need to be a good risk manager are already ones that we have. You need a strong understanding of asset and liability risks, good modeling capabilities, and generally strong analytical capabilities. What actuaries are typically missing is hands-on investment management or trading experience. That's why we have a combination of actuaries and investment people in the risk management unit at Prudential.

The primary focus of my unit so far has been on what we call financial risks, meaning market credit and insurance risks. These are very important. We shouldn't lose sight of the fact that this survey indicates that the biggest risks in the insurance industry today are distribution channel productivity, increased competition, and changing customer demand. In addition, there is a long list of other business and operating risks, including compliance and tax law changes and new laws and regulations. They're going to have a significant effect on our business.

One of the things that we have been struggling with is the extent to which these kinds of risks can be measured and managed. One of our projects for early next year is to try to develop an approach for including business and operating risk in our risk measurement framework.

Tricia didn't highlight the pieces of the survey that had to do with valuation and nonforfeiture, and there are a couple of interesting sessions on those subjects at this meeting. The results of the survey were not surprising in that they indicated that the proposals to change the current valuation in our forfeiture law are being very carefully monitored by senior actuaries. What was a little bit more surprising is the depth of feeling with regard to changes in the nonforfeiture law. Twenty-seven percent of the respondents indicated that they are against or strongly against those proposed changes. I have to admit that my feelings on that subject are mixed. The

most appealing aspect of the proposed change to the nonforfeiture law is the possibility of more easily accommodating new product design, particularly the prospect of building products that combine life and/or annuity or health insurance features under a single contract (either simultaneously or sequentially over the insureds lifetime).

Having that kind of product flexibility would give a great competitive advantage, if we don't undermine the tax advantage status of our current products in the process. In many ways, I kind of like the idea of the discipline of a plan, which will encourage the development and implementation of a philosophy for how nonforfeiture values and other nonguaranteed values would be determined. I think that the issue here is making sure you want to retain sufficient flexibility within that plan, in order to accommodate whatever comes down the road in the future.

On the other hand, I also question whether a traditional life insurance product, without the safety net of some minimum cash value guarantees, will fly in the marketplace. The survey indicated that almost one-third of the actuaries from large companies were opposed to the direction of the nonforfeiture law of proposals. I really wonder if part of that reaction was generated by the fact that larger companies may have been harder hit by sales practices and other market conduct issues. I have some hesitation about the wisdom of asking the public to accept the total "trust me" product.

The objectives of the recently formed valuation task force seem to make a lot of sense. I think that the task force has done a good job of beginning to define all of the challenging issues relating to fulfilling the fundamental objectives that are laid out. In general, the actuaries who responded to the survey tend to feel less strongly about the valuation project. Perhaps it is because the work of the task force isn't as far along. There are some consistent themes that underlie both of these efforts. First, we're clearly headed toward less reliance on formulaic approaches and more reliance on actuarial assumptions, methods, and judgments. Therefore, we will probably end up with more flexibility and more responsibility than ever before. I think that this new world is going to really emphasize the importance of having good data, good systems for analyzing those data, and excellent modeling capabilities. Keeping our collective tools up to date will be a challenge to our education and examination (E&E) as well as research systems. It will be a challenge for every practicing actuary to keep his or her skills up to date.

I also believe that the new nonforfeiture and valuation systems will challenge the profession to develop and maintain appropriate standards of practice for this new environment. There are quite a few people in the U.S. who look across the border at Canada, when they consider these issues. If we are heading in this direction, I

think we should take a close look at the Canadian standards of practice that tend to provide much more specific guidance.

I think that these new directions will also mean substantially different relationships with regulators. More flexibility is going to provide a significant challenge to the resources of the state insurance department and perhaps demand a much closer working relationship between companies and their regulators than we've had in the U.S.

With respect to product pricing and financial performance, I've already mentioned a couple of the biggest challenges I see with pricing new products. One is making sure that we choose appropriate assumptions and then communicate the rest of the products appropriately. With regard to financial performance I'd like to touch on three other challenges. Clearly, one of the largest issues most of us face is integrating the entire financial management process. Now what do I mean by that? I think the financial management process starts with understanding your overall business strategy, designing products that fit that strategy, reviewing experience and choosing appropriate assumptions for new business. We must make sure that the way products are underwritten is consistent with the mortality or morbidity assumptions that are being used to price the product. We should develop and implement a suitable investment strategy, administering the product according to its design and contract terms. We need to redetermine dividends or other nonguaranteed elements in line with emerging experience, set appropriate reserves, and review the results of the product in a timely and accurate way. We can use the information from all of those steps to gain insight into how to design and price the next generation of products.

Now if anybody has managed to get each and every one of those pieces working smoothly together, I congratulate you. I'm willing to pay you a lot of money for your secret because doing all of that requires a tremendous amount of thoughtful planning, excellent data capture and systems support, and outstanding communication among everybody involved in the process. I think you also need a fair amount of consistency in methods and operations over a long period of time. For those of you who have mastered the financial management cycle for individual products, I'll be really impressed, especially if you can track customer as well product profitability. I think we're all ultimately going to need to do that to be truly competitive in the future, and I think we're going to need to move away from a fixation on achieving a minimum return on equity (ROE) on each product line and more toward an emphasis on optimizing total company results by understanding which customers and which market segments deliver the best results. That's not to say that we won't need to understand the contributions of these product lines, but I think we need to go beyond that understanding and look at an even bigger picture.

Another immediate issue that Prudential is facing is continuing our transition to GAAP. We had a version of GAAP for a while at Prudential, and we recently produced GAAP numbers for the first time for 1995 and 1996. We're doing that for 1997 as well. At this point I think we're still riding with our training wheels, and part of that is due to the newness of some of the systems and methods that are being used for participating life insurance products. There's still a need for us to put better analytical tools and processes in place, so that we can understand what's currently driving and what's likely to drive our GAAP income statement. At this point I think we need more experience with GAAP and an understanding of all of the interrelationships that affect the final results.

In terms of opportunities to improve performance I was intrigued by some of the survey responses. Expense control in general and the cost of distribution in particular seem to be on everyone's mind, and there's some optimism from the survey results that acquiring blocks of business to achieve economies of scale and to realign performance centers will also have a positive effect.

In addition, many of the respondents saw potential in developing new products and entering new markets. Given today's thinner margins and the intense competition that most of us are going to face in the future, I'm less sanguine that new products, by themselves, are the answer to improve performance. I think all of us are going to be chasing after those profitable new markets. I wonder if there's any sustainable advantage to be found there. What we need to do is rely on improving the fundamental pricing factors of our business in order to improve long-term performance.

Relationship with senior management. I struggled a bit about how to respond to the questions on relationships with key management. Most of Prudential's top management, as I mentioned earlier, is from outside of the insurance industry, primarily from banking. They are extraordinarily bright people who have learned an awful lot about our business in a short period of time. I think they brought a good refreshing perspective about how to run the company now and in the future. I think that they struggled a bit at first to understand the long-term nature of our products and the special characteristics of participating business, especially in a mutual company environment and because of the ranging complexity of the transactions that are required to service the business. I think that we're very fortunate to have that new team. I also should mention that Prudential has a very active and committed board of directors that is also a huge advantage for us.

So what relationship problems do exist for actuaries at Prudential? I think the good news is that our senior management recognizes actuaries as the people who truly understand our products. The bad news is that there's still a little bit of a tendency to view the actuarial staff as very smart super technicians. I think that perception is

changing as our new team gets to know actuaries and our range of knowledge and skills and abilities. To some extent, we're still being stereotyped as the nerd patrol a little bit more often than I would like to see happening.

I think there is a more serious, current issue in terms of the relationship of actuaries with some of our other peer groups in the company. Our investment staff, for example, still wants us to be able to reduce the world of products to one simple number. Just tell them the duration of our participating life insurance business correctly to two decimal places and they will be happy. Similarly our comptroller staff expects us to be able to explain all the intricacies of our GAAP reserves and deferred acquisition cost (DAC) amortization in 25 words or less. It is not that easy. We really need to work on education and communication. I'd be interested in hearing whether or not you are experiencing any of those same communication issues.

In terms of career opportunities for actuaries at Prudential, I think that the range of possible options is enormous. We currently do have actuaries or actuarial students in marketing, information systems, operations, field compensation, compliance, risk management, and business group chief financial officer jobs. From time to time, we also place people in portfolio management and strategic planning, underwriting, and other nontraditional assignments. I do have a couple of more specific comments about that.

First, placing actuaries or actuarial students directly in our investment areas does present some challenges. Now that doesn't mean that many of our actuarial assignments don't have a high investment-oriented content, but we found that once someone begins functioning as a deal maker or as a portfolio manager, it's hard to get that person back on the liability side of the balance sheet.

The work itself is very appealing to someone with an actuarial background. The compensation plan for Prudential's investment professionals is different (meaning higher). My understanding is that many other companies face the same problems when they try to repatriate an actuary who has crossed over to the other side.

I already mentioned risk management as an area that could provide significant growth opportunities for actuaries because of the kinds of skills that we have. While the survey participants in general were very optimistic about career opportunities, I do want to remind you about some of the comments that we heard at this meeting. There are a lot of very bright and very aggressive competitors for jobs, and that competition is going to increase as the lines between various kinds of financial services companies and products keeps blurring. Actuaries can't afford to be complacent and assume that their traditional turf will remain protected. We do

want access to all of these opportunities, but many other people want to play in our sandbox too.

Do you really need an actuary to price the deferred annuity? I don't think so. So I think we all need to support the efforts of the Society to keep our profession strong and relevant. If we do that, we'll all have a much brighter future.

Mr. Douglas Menkes: When Tricia asked me to speak at this session and told me it was on trends in the life insurance industry through the eyes of the corporate actuary, I said, "I've only been at this for a little less than two months." She said, "That's no problem. By the time we have the meeting, you will have twice as much experience."

I'll give you a simple overview of the planning process that we go through with the Equitable. I think it's probably similar to something a lot of you do and it helps me focus on some of the key issues that were raised by the CEOs and the actuaries.

We developed an updated business plan, covering several years. It reflects input from marketing, investment, and accounting areas. We project statutory and GAAP earnings, as well as risk-based capital ratios, return on equity, and earnings per share. Our primary focus is GAAP. When you're a publicly trading company, you have to pay a lot of attention to your earnings and the public's expectations of your earnings, and you must run an insurance company as well. Obviously, we're concerned with statutory accounting; it's something we try to do a good job at. Certainly risk-based capital, where we're headed, and how we use our capital is very important.

The projections reflect many assumptions. As I think about the risks that exist to our achieving these assumptions, I see many of the same issues that were raised by the CEOs, and those of you who responded to the survey. The particular issues I will talk about are increased competition, distribution channels, productivity, changing market and customer demands and expense management. I think it's important that we realize that we need to do more than recognize what these issues are. We have to be prepared to try to do something about them both as actuaries and as employees or management of the company. We have to be in a position to implement business strategies, which will help us achieve our plans, help make some of these assumptions come true, and help us manage the risk that we're identifying as being critical to our success.

I found it interesting that us actuaries were much less optimistic than CEOs about our ability to address these issues or our preparedness to deal with the issues, with the exception of sale practices and compliance issues. Furthermore, we saw

expense management as much more of a critical issue than CEOs did. Now I'm assuming that most of the CEOs who responded were not actuaries. I mean there was not much overlap here. So I don't know whether, as a group, we tend to be more pessimistic, or whether we have some good reasons. I find expense management fascinating.

Have any of you ever heard the assume a bridge story? I heard this about 20 years ago. But I think I'm going to tell the story because I think it will help us realize why we think expense management is such a critical problem. I'm changing the story a little bit to make it politically correct. It deals with one of these chain building efforts, where the CEO, the CFO, the chief actuary, and the chief investment officer, are out in the wilderness and a volcano erupts. This bed of lava starts rolling toward the four executives, and they start running to try out race the lava. They do a fairly good job until they get to this huge ravine and realize that if they can get to the other side of it, they'll be safe because the lava won't fill up the ravine. The problem is there's no way to get there. The actuary says, "No problem. I'm going to assume a bridge." Well, it's not that simple. The lava caught up with them, and all four of them died in the lava. I think that this illustrates the problem with expense management. It is not something where you can just assume you'll outgrow your problems. A number of years ago, there were quite a few small- to medium-sized companies, and you could say, "I just don't have enough business in force to support my overhead and my fixed costs."

Now we're talking about an industry where most of the large companies can't achieve expense levels, which they need to meet their pricing assumptions. The pricing assumptions reflect what shareholders would require to be satisfied with respect to recurrence in their investment. It's a critical issue. I think most of you have probably seen actuarial appraisals, particularly when they're prepared by sellers, where the issue of expense overruns is dealt with. You basically assume that whatever level you're spending at will grow with the consumer price index (CPI) and you'll sell a whole lot of business in the future. Five or ten years down the road, the lines cross and you might find you have outgrown your expense problems. It really doesn't work that way. If the problems stem from not doing things wisely and from not operating efficiently, a major reengineering effort is necessary. As actuaries, we understand that this is a complicated issue. It's not as simple as basically saying, I'm going to cut staff. It involves technology as well as a number of other things. And I think that's why we recognize this as being a much more serious problem. It doesn't mean that the CEOs don't think it's serious. I'd have a hard time imagining that they don't understand these issues as well. But I think they were focusing on some other things when they filled out the survey. In the overall scheme of things, this really caught our attention because we're much closer to it.

The illustration actuary regulations that exist may be a reason why we actuaries felt much more optimistic about our ability to deal with market compliance issues than the CEOs. I say that because this is something that we're involved in. The regulations were written in such a way that actuaries basically have to sign for the validity of the assumptions and the projections. We feel that we understand it, and therefore, we're able to deal with it. I'm wondering whether we're really dealing with the solution as opposed to helping just comply with the regulations that are in front of us. I think, in the long run, the illustration actuary regulation runs the risk of having the public turn on the actuaries the next time interest rates go down. The performance of the policies don't live up to what was projected. They'll look at this and say, "This has the actuarial seal of approval on it. The companies' illustration actuary said that this is a self-supporting illustration." It probably is, but I think that we run a risk. Even though these regulations are in place, this is not a real good long-term solution to the fact that the life insurance industry has an image problem, and I don't really know how to deal with that image problem.

I want to talk a little bit about financial performance measurement. I found it interesting that most of the actuaries who responded to this survey were only moderately satisfied with their ability to measure economic contributions of lines of business. Certainly when you have more than one line of business in a company, the economic performance needs to be a function of the land where expenses are allocated. And I don't know whether the frustration of actuaries is attributable to that or to other factors. I'd like to learn a little bit more about it.

Certainly if you have a line of business where you have a relatively low return on equity, but the risk-based capital is 400%, that's not really an unprofitable line of business. It might just be overcapitalized. We're starting to look at something additional to regular lines of business or product reporting. It is something that Helen mentioned a little bit about. This is reporting a strategic business unit as opposed to a product. It has to do with really taking another look at the way your business performs. At the Equitable, we sell business through two distribution methods. One is our standard career agency system, which we refer to as our retail business. We've developed another entity called, Equitable Distributors, Inc, which is really more of a wholesale operation to develop and market products through alternate channels, like banks and stock brokerage firms. We certainly want to begin looking at the profitability of our business both by wholesale and retail as opposed to by product. For that matter we would like to look at it within retail by agency, by agent, and to some extent by customer.

When this was first brought to me, I was kind of cynical, which I tend to be. What does it mean to look at the profitability of a policy by customer? We all know that if this was a life insurance policy, and the policyholder lived, that was good. We had

a profitable year. If it was an annuity policy and the policyholder lived a year, we probably didn't make any money. We might even have lost some money if there were life contingencies. I think about the issue of changing market and customer needs and how we deal with that. This began to make some sense to me. I don't think we really understand some of the characteristics of what drives profitable policies and unprofitable policies. Certainly when it comes to underwriting we think we do, and when we study mortality results we tend to group the policyholders a priori in underwriting categories. We ask how profitable were the ones that were medically underwritten, how profitable were the ones that were guaranteed issue, and how profitable were ones that were at various points in between?

Another way to look at it is to basically take out a clean sheet of paper and say, let's look at all the policies that we made money on, and all the policies that we didn't make money on, and see whether we can identify some characteristics about those policies that will help us target future customers more efficiently. We must understand where we're making money and where we're losing money. So that's where this began. I'd be curious to know whether you're having to deal with that. I think it presents very, very difficult financial reporting challenges for us as actuaries, particularly as you move into this era. What do you do with the existing deferred acquisition cost? How do you ever attempt to restate it at the customer level? There are very interesting problems that we're going to begin dealing with at the Equitable.

Next I want to talk a little bit about managing risk. I find this fascinating. Ninety percent of senior management perceives the roles that actuaries play in managing and measuring risk to be valuable (51% said they were very valuable and 39% said they were somewhat valuable). That's good. However, about three-fourths of those of who responded to the survey spend less than 25% of our time measuring and managing risk, and 97% of us spend less than half of our time measuring and managing risk. This is in an area where we had almost universal agreement by CEOs that this is very valuable. I found that interesting, and I just thought I'd raise it as food for thought.

In terms of the tools to measure and control risk, I want to mention something else that I spend a lot of time thinking about. It has to do with how to manage what goes on. This encompasses more than managing risk. It encompasses projecting assets and liabilities as well. In order to do cash-flow testing and duration and convexity and value-at-risk and dynamic solvency, you need to be able to project your assets and liabilities. We project them for other reasons that are in addition to managing risk, such as for financial planning. We have the business plan, which I described to you earlier. We use these projections to project future margins for

amortization of our deferred acquisition cost and for our interest-sensitive business. There is a provision of the New York Insurance Law 4227 dealing with how much new annuity business you can write. The law is kind of archaic right now, but you usually end up having to prepare projections of your annuity business and send it in and request a waiver or an increase of your limits.

There are some new regulations coming out from the SEC about market risk disclosure, which involve applications of cash-flowing testing like shocking your interest rates 100 basis points either way and measuring what happens to the value of your business. We're beginning to work with embedded value. As I think about all of those applications as well as these, as a corporate actuary responsible for managing these processes, I know that if we approach this or these projects one at a time, we're doomed to work nights and weekends, and probably can't even complete everything.

What I'm trying to do is work with one chassis, and hopefully one model so that we can use a lot of what we do for cash-flow testing and for all of the other applications as well. It involves a lot of planning and managing deadlines to make sure that not everything is due the same day. When we get into the discussion, I'd be curious to know how you deal with these issues.

The only other thing I'll cover is expanded opportunities for actuaries. I think that the future for actuaries is good, particularly those who can communicate, who are multi-dimensional, and frankly who are willing to work hard. When I think about the concept of a traditional role versus a nontraditional role, sometimes I have a little bit of trouble doing it that way. For instance, I think we would all agree that cash-flow testing is a traditional actuarial function. This didn't exist 15 years ago. I don't know how to look to the future. I think that when it comes to managing risk and measuring risk, those of us who are bright enough to do it and who are good communicators will succeed and there will be a place for us. We probably underutilize our actuaries right now. I think we have a bright and rosy future.

Mr. Isadore Jermyn: The question of distribution channel productivity is an issue that we have to deal with at Mass Mutual. An observation that often comes up is that the distribution channel (the agency) actually seems to be doing quite well. The compensation that the agents are earning seems to be growing quite rapidly—much more rapidly than the growth of the compensation that the company is paying on traditional life, annuity, or disability products. Part of what we see is a distribution mix issue or product mix issue. We're seeing the agents being very productive and not necessarily in the products that the company has its primary interest in. So I didn't know whether the responses that you got have detail that would elaborate upon whether it's an observation that the agents are not being that

productive or whether they are not being productive in the products that the company would like them to be selling.

Ms. Guinn: There's not a whole lot of detail in either of the surveys about that issue, but I think you raised an important point. It ties into some other work that we're doing right now in another survey that's being conducted for which results are going to be presented in New York on sales force efficiency. About 20 companies with mainly a career agency focus agreed to participate in the survey, and it covers about 55% of the industries' career agents. It will look at issues such as the ones you're alluding to. I think that is one of the big focuses in many companies. We are looking at what we are paying our agents to do. Our compensation schemes are all very complicated, and we have an industry that has managed its distribution system by the compensation system rather than telling them what to do in large part. Companies are reexamining the message in those compensation systems. Are we paying people to do what produces value for the customer and the owners of the enterprise?

Mr. Menkes: I think there are probably two issues in there. One is, are the agents busy selling the products of other companies? Or is it just that they're not selling the products that are most profitable to you, even though they are your products? I know that at the Equitable we have a channel for our career agents to sell products of other companies, where we don't offer the product. It was designed as an accommodation in which we'd much prefer to see our own products sold, particularly when we introduce one that's offered by the competition, but it is a problem.

The other problem area is I think where the compensation structure for an agency force requires a certain threshold in order to receive benefits and qualify for certain other levels of fringes. The agents work hard to reach that level, but then they don't sell a whole lot of your own product. They go sell somebody else's product, where the compensation is structured a little differently. It's more of a personal producing general agent structure and that's a problem. It has to do with where the bar is.

Ms. Galt: I guess my only comment about this is, I think this is an area that requires a lot of intense analysis because there is a danger of jumping to erroneous conclusions, unless you really take a look at what's going on.

Ms. Mary Ann Brown: I was very interested in hearing your comments about nontraditional management from outside the insurance industry. I would like to hear some ways that you think are refreshing about the way they look at the business and how you changed your communication to explain what we do. I know we've been fairly intrigued with finding new ways to explain it to our nonlife

and financial banking partners, and trying to explain how risks are collared and how some of the life insurance risk is predictable. I'd like to hear about how to discuss the correlation of some of these risks like lapse, mortality, morbidity, and those kinds of things. It has been very interesting for us, and I'm sure you must be challenged when having to explain this to people from the banking industry. I'd like to hear how you do it.

Ms. Galt: I think this education process takes place over a fairly long period of time. I don't think its possible for you to just sit down in one hour and explain all of these issues. To some extent, it's a matter of communicating fundamentals and the various issues come up when you go into these things in more depth. One of the things that seems to work is to try make parallels between products or concepts that these people are already familiar with from the banking industry and to try to compare and contrast how the insurance business is different or similar to things that they're already familiar with.

As I mentioned, I think that some of the challenges have been just the long-term nature of many of the products that we sell, as opposed to a banking environment where the time horizon of a lot of products tends to be a lot shorter. I've been very pleased with the level of understanding that developed very quickly about the nature of mutual life insurance companies and participating products. I thought that was going to be a difficult issue to deal with. Actually, it has turned out not to be, which I think is really a credit to the people that came into Prudential.

We also have had formal sessions with our Board of Directors on some of these issues. We've actually had teaching sessions on dividends and reserves and other actuarial issues. I was surprised, given the demands on their time, at how receptive they have been. I think that makes them more effective to have basic grounding in a lot of these concepts, and I think that they feel more comfortable that they can ask better questions as a result of having gone through that education process. I've been very pleased with their receptiveness to just having education sessions. I guess the most recent one that we did was on the new illustration actuary concept and what that all meant. They have been very interested, and they asked very perceptive questions about that whole subject.

From the Floor: I think both panelists talked about GAAP, or at least mentioned GAAP. How do you utilize GAAP for actionable management information? In our organization, for example, we prepare GAAP but we also use embedded values to really get at the economics. Any comments on that?

Mr. Menkes: GAAP is the primary focus of the people who watch our company—Wall Street. As result, it kind of drives our day-to-day lives. We certainly tend to

look at our management actions in terms of how they might impact our GAAP results. When we design products, we are trying to develop products that provide return on equity and return on capital of certain threshold rates. When we measure financial performance, we're trying to be consistent and look at our results in terms of return on equity.

Is this the best way to analyze what's going on in the company? I don't think so. I actually think embedded value analysis, if done properly, without a whole lot of subjectivity, gives you better indications of where your business is heading, so we're beginning to look at embedded value. Now the real world for publicly traded companies is a world of GAAP, and we use it all the time.

Ms. Galt: I mentioned that this is an area that is a challenge for us. We did have a version of GAAP at Prudential that we called management accounting for quite a few years. We just converted to real GAAP very recently. In fact, we produced a final set of GAAP numbers for 1995 and 1996 earlier in 1997. As I mentioned, I think we are still riding with our training wheels on, especially in terms of figuring out how to analyze our GAAP results. I think it's going to take a while. At this point I don't know whether we have any really good way of knowing how these numbers are going to behave or what will happen if this factor changes. What's going to come out in the end? I assume that a lot of the people in this room just had more experience at this point than we do. So I think it's just going to take time for us to truly understand our GAAP numbers.

Ms. Guinn: I think that Doug's point about the equity analyst is really key. Many companies are driven by GAAP because that's what Wall Street is interested in. If you look at the merger and acquisition world, when there's a private transaction or a sales company, there's usually an actuarial appraisal on the table, and that's basically what embedded value is the root of. That's commonly accepted. In 1993, when there were not private sales, there were public offerings in the market. The whole pricing of those public offerings was done off of GAAP multiples, and there weren't appraisals at the table. I think that there are companies, particularly European companies, that are also listed on the New York Stock Exchange, that have been talking up embedded value to the equity analyst and going through an education process about the long-term nature of the business, what the inherent return on capital is in the business, and how that differs from current quarter GAAP earnings. There's still quite a ways to go to move them up the learning curve.

Ms. Sue Ann Collins: I have a follow-up comment to Helen's observation on the number of actuaries who did not seem to support the change in the nonforfeiture legislation. I guess my remarks are more in the nature of a comment rather than a question. It would seem to me, with the added flexibility, that the new regulation

may have, as you point out, a great burden on the actuary. Given the state of how litigation and the lawyers work in the U.S. and what we've seen in the area of market conduct, I just wonder if some of the resistance of actuaries to changes in the nonforfeiture legislation, that gives them a lot more freedom, may not indeed be driven by the legal system we have here in the U.S.

Ms. Galt: Yes, I think that's a very good observation. When we look at Canada at the model for some things, I think that we have to recognize that the whole regulatory and legal environment is much different. It seems to be a much less litigious society. I think that's a serious issue for us.

Mr. Menkes: I echo that comment. I think that when you read the CEO survey, you'll see that the CEOs identified simple products as something that they see as being desirable in meeting their business strategies down the road. When I think of the proposed changes to the standard in our forfeiture law, they may make a lot of sense, but what do they really do for us? Any time there is a major change, people get suspicious. We're operating in an environment where, unfortunately, there is a lot of distrust towards life insurance companies. Now we are saying, "We have a plan. We can't tell you what the guarantee is going to be anymore, but we have a plan and it's on file. Trust us." I just think that is asking for trouble, even though, theoretically, there might be a lot that can be said for it.

Ms. Guinn: One of the parts of the survey was asking actuaries where there was room for improvement or where improvement was going to come from. I was just trying to find a list of all of the options that were mentioned. As I recall, the top two were alternative distribution and new products. Also, what sort of new products do you foresee that might actually be able to make a meaningful change?

Mr. Menkes: We're dealing with an aging population. The insurance business has concentrated on gathering and managing assets for years. As the insurance industry and the population grows older, we're going to have to try to find ways to distribute those assets, probably through income products. What will happen is our competitors could be the banks who will glob onto these assets with products of their own. I've heard of things like immediate annuities with cash values or partial cash values. I think the general class of products are geared towards the older people, and we can help to get back, in a systematic and rational way, the money that we've accumulated and managed for them over the years. This has to be the biggest area of opportunity for new products.

Ms. Galt: One of the things that intrigued me was I had hoped that there isn't an assumption in there that somehow margins on these new products are going to be substantially bigger than the products that we currently have. I really question whether or not that's going to be true.

Mr. Kurt K. von Schilling: This product development question intrigues me. I would like to see the panelists debate it a little bit further. What I see developing in the future is that the customer wishes to have more choice and freedom to change his mind at any point in time. The product design has to be simplified to allow customers to interact more frequently. To offer a person who is going to live for another 40 years an immediate annuity at retirement does not serve a purpose because the level income does not meet his needs. So you need to come into a product design that will meet the clients' and customers' needs over time. Maybe a little bit more income is needed up front. A suggestion could be building on the various mutual funds that are in existence and providing a scheme of withdrawal from the various funds in a systematic manner. As such, there is going to be capital and income derived to meet the client's needs over his or her lifetime. I've seen some modeling done, which is very intriguing. Somebody has looked at a payout at age 60 in a collection of mutual funds and said, if you are doing a systematic withdrawal from these funds in line with what an immediate annuity would have paid you, you can defer that decision by 20 years, and you can have 95% assurance that you would have come out 20 years hence at the same or better value. So that kind of customer client development or product development concept has to be integrated and considered in the future.

Mr. Menkes: I don't think I could have said it much better. One of the things that we need to be careful about is as we introduce flexibility, we give our clients more options to select against us. We must recognize what those options are and price them accordingly. One of the things that we've begun doing at the Equitable has to do with one of our variable annuities series. We offer a minimum income benefit. This was first designed to encourage people to stay in the market longer than they normally would have as they approach retirement age. One of the principles that we've all heard our whole adult lives, refers to managing our money. As you get nearer and nearer to retirement, you need to pull out of the market a little more so that stock market drops don't have as big an impact on us. That's all true, but everybody loves the market. We've introduced a guaranteed minimum income benefit that basically protects the customers from significant drops in the market at the time they wish to annuitize. I think that gets at what you were saying. It is certainly an option where I think some degree of risk is involved. We've tried to price for it. We've actually used reinsurance to insulate ourselves from a good portion of the risk, but I think it gets at the types of things that you were talking about.

Ms. Galt: I agree with Doug's observation that this kind of flexibility is what is needed to effectively compete in the future. Pricing those options could be a little tricky. Ironically, one of the advantages of the nonforfeiture proposals that were put on the table would make that kind of product flexibility easier to do. So we're in a

bit of a dilemma in terms of not loving the nonforfeiture proposals and yet wanting the traditional flexibility at the same time.